

SUPERIOR COURT OF ARIZONA  
MARICOPA COUNTY

TX 2002-000605

12/13/2007

HON. THOMAS DUNEVANT, III

CLERK OF THE COURT  
S. Brown  
Deputy

LEVEL 3 COMMUNICATIONS LLC

PAUL J MOONEY

v.

ARIZONA STATE DEPARTMENT OF  
REVENUE, et al.

FRANK BOUCEK III

**UNDER ADVISEMENT RULING**

The underlying facts are not in dispute. Level 3 owns an extensive system of fiber-optic cables and conduits, both installed itself and purchased from distressed competitors. This infrastructure apparently cannot produce anything approaching the revenue projected to be generated from it, due to persistent oversupply. The causes and effects of this oversupply will be analyzed in more detail below. Level 3 asserts that its conduit is entitled to a reduction in value for obsolescence (functional and economic) because of technological advances in fiber optics subsequent to the installation of its system, which it claims to have resulted, at least in part, in a decline in the market value of the system. The Department of Revenue counters, first, that such loss of value cannot be factored in under the statutory directive and, second, that the amount of loss was not properly established.

This case turns largely on the definition of “obsolescence,” and how it fits within the statutory valuation scheme. As long ago as 1931, the United States Supreme Court observed that the word “obsolescence” “is much used, and its meaning depends upon and varies with the connections in which it is employed.” *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648, 653-54 (1931).

The Court’s analysis is directed by the applicable statute, A.R.S. § 42-14403, by the Memorandum Decision of the Court of Appeals in *Arizona Dept. of Revenue v. Qwest Corp.*, 1

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CA-TX 03-0010 (Ariz.App. 2004), and by two recently published cases, *Arizona Dept. of Revenue v. Questar Southern Trails Pipeline Co.*, 215 Ariz. 577 (App. 2007), and *Eurofresh, Inc. v. Graham County*, 1 CA-TX 06-0002 (App. 2007). The Court's interest in *Eurofresh* is not whether the plaintiff in that case met its burden of proof, but solely in the appellate court's definition of economic obsolescence and its instructions as to when it may be applied. The statute provides the exclusive method for valuing telecommunications property. It does not define, or in the version in effect at the relevant time even mention, obsolescence. (A 2006 amendment, at subsection (C)(2), expressly provides for including obsolescence as part of depreciation, but the definition it provides is unhelpfully circular: "'Obsolescence' means a reduction in the value of an asset resulting from functional or economic obsolescence.") *Qwest* held that obsolescence could be considered even under the original statutory language. But it did not define obsolescence. Nor can useful guidance be drawn from its facts: *Qwest's* property, metallic cable and analog switches dating from the Roosevelt Administration, was functionally obsolescent, so the court had no need to develop the distinct concept of economic obsolescence. *Questar, supra* at 580 ¶ 12, defined economic obsolescence as "a loss in value caused by forces external to the property and outside the control of the property owner" (quoting *Magna Investment & Development Corp. v. Pima County*, 128 Ariz. 291, 293 (App. 1981)). This bare definition and similar definitions taken by the *Eurofresh* court from Appraisal Institute, *The Appraisal of Real Estate* (12<sup>th</sup> ed. 2001) and Black's Law Dictionary (8<sup>th</sup> ed. 2004), are broad and ostensibly suggest that economic obsolescence could result from transient market fluctuations, provided only that the market is not controlled by a single participant. The effect of this broad definition on tax assessment would be to require valuation, not just of inventory, but of permanent assets by a kind of mark-to-market accounting, forcing assessors to research current market values for every asset and creating significant unpredictability in tax revenues. *Eurofresh, supra*, provides both clarification and narrowing of this broad definition enunciated in *Questar & Magna*.

*Eurofresh, supra* at 23 ¶ 37, qualifies the *Questar/Magna* test. "A taxpayer claiming external [or economic] obsolescence must offer probative evidence of the cause of the claimed obsolescence, the quantity of such obsolescence, and that the asserted cause of the obsolescence actually affects the subject property." The latter requirement, that the property be actually affected by the cause of the obsolescence, distinguishes the situation where market fluctuation does not represent termination of demand. See *Hometowne Assocs., L.P. v. Maley*, 839 N.E.2d 269, 273 (Ind. T.C. 2005), quoted in *Eurofresh, supra* at 13 n.6 (obsolescence exists where property is "constructed for a need which has subsequently been terminated due to actual or probable changes in economic or social conditions"). Termination is by its nature permanent. Take two hypothetical examples. The demand for buggy-whips essentially disappeared permanently, save for a handful of uses, when the automobile replaced the horse-drawn buggy. The price of buggy-whips dropped – permanently, we can say in hindsight. It is fair to say that the buggy-whip is obsolescent for its intended use. Consequently, any specialized machinery

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used in their manufacture, even if it incorporated the most advanced technology for buggy-whip making, became economically obsolescent when the automobile arrived. By contrast, high definition plasma televisions are desired by consumers. But suppose ten separate factories, for whatever reason, each produce a billion of them. With the market saturated, the price of plasma televisions will likely fall just as the price of buggy-whips did, but not because the demand for plasma TVs terminated. A plasma television manufacturer, therefore, cannot reduce the taxable value of his equipment by asserting that it is economically obsolescent.

With this instruction in mind, the Court now turns to the facts. The evidence showed an industry in economic difficulty: the “perfect storm,” as Plaintiff’s counsel described it. Anticipating an exponential increase in demand for internet and other telephone-based services, numerous companies installed huge amounts of conduit and fiber-optic cable. Technological advances occurring during this expansion increased the capacity of each fiber, allowing latecomers to install cable for much less per unit carried and thereby permitting expansion beyond the internal return projections of early installers. Combined with this, the estimates of demand proved far too optimistic. The result was a cascade of reorganizations and bankruptcies. What cannot be overlooked, however, is that demand did not terminate: in fact, it has steadily increased, though at a much slower rate than expected. This is the plasma television hypothetical, not the buggy-whip. Level 3 simply underestimated the future supply of fiber-optic capacity. Mere erroneous business judgment does not create obsolescence. The analysis is not fundamentally changed by the introduction into the equation of more-efficient cables. Level 3’s cables carry signals just as well as newer ones: it simply cannot carry as many. In this regard, the position of Level 3 is the same as that of a hypothetical service provider who installed the newest product, but made a bad deal with the manufacturer and paid the same price per unit capacity: both would have the same return on investment (ROI). The suboptimal return for the hypothetical provider cannot be attributed to obsolescence; neither can the return enjoyed by Level 3. The difference that the hypothetical provider knew before projecting its ROI what both the initial investment and the subsequent market-clearing price would be, and Level 3 did not, is immaterial. Level 3’s investment is what it is. That the investment was greater than what it would be to install the same capacity now does not create obsolescence. The holding of *Eurofresh* that only that obsolescence which actually affects the property can be claimed precludes its inclusion here.

The issue much argued in these proceedings over whether Level 3’s valuation of its property, which included not only its system within Arizona but in other states as well, satisfied USPAP standards, turns out under *Eurofresh* to be immaterial. A.R.S. § 42-14403, as interpreted in *Qwest*, dictates that telecommunications property must be valued at historical cost less depreciation (based on standard formulas) and obsolescence. Since the loss in value of the property was not caused by obsolescence, it cannot be deducted. Therefore, the amount of lost value does not matter.

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Therefore, IT IS ORDERED Judgment is entered for Defendants and against Plaintiff.